

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

23 April 2006

Some of the fog that has been making economists' crystal-ball gazing more difficult than usual seems to be lifting, enabling us to sketch what the rest of this year might look like.

We can safely assume that President Bush has written off any chance of major progress in the Doha round of trade-opening talks, and decided to move cutting the budget deficit up on his list of legislative priorities. That is clear from the fact that he has moved Rob Portman, the US Trade Representative, over to the Office of Management and Budget (OMB). It is hoped that the former congressman's popularity and his reputation as a budget balancer will enable him to rally the fractured Republican majority to support the President's spending cuts. Portman's former deputy, and now his successor, Susan Schwab, is able, but unlikely to carry as much weight with free-trade skeptics in congress as Portman. If you doubt that Doha has been derailed, consider the chortle of Lori Wallach, representative of a group opposed to further trade-opening, who told the press, "This does not bode well

– ha, ha, ha! – for Bush's trade agenda. What a tragedy!"

On the trade front it is also reasonable to guess that China will finally do something about the rampant theft of intellectual property (IP) that it has encouraged. On his visit to Microsoft's home town of Seattle, Washington, Chinese president Hu Jintao finally promised to require computer manufacturers to include licensed rather than pirated software in their machines. This concession was aimed at defanging critics in Washington, and designed to protect the IP that China's own firms are starting to develop. Bill Gates, host – well – he provided the dining room for the 100 guests, the governor being the announced host – to Hu, glowed in appreciation, as did the founder of Starbucks when the Chinese president expressed a desire to sit sipping coffee in one of his many shops in Beijing.

China will also continue the policies that allow its undervalued currency to inch its way upward. But Hu made no concessions to President Bush's concerns on important foreign

policy issues – the nuclear weapons policies of Iran and North Korea, and China’s rapid expansion of its military’s ability to project power in the region. Instead, he seemed content to rally support from American businessmen (Boeing, Microsoft, Starbucks, and recipients of some \$16 billion in orders), and leave our President’s plea for international cooperation unanswered. Lenin once famously said that a capitalist will sell you the rope to hang him with – update that to software, aircraft and grande lattes.

Meanwhile, the dollar is likely to drift downward. The Fed is giving clear signals that it will soon stop its ratcheting up of interest rates after 15 consecutive ¼-point rises, perhaps calling a halt at 5%, perhaps at 5¼%. The Fed is sensitive to the criticism that it typically overshoots when it takes rates up, and has its eye on developments in the interest-rate sensitive housing market, which is finally cooling.

Housing starts fell 7.8% in March, and mortgage applications have dropped in response to a rise in mortgage interest rates – 30-year fixed-rate mortgages now command 6.5%, up from under 6% last year and the highest rate in almost four years. Little wonder that home builders, their inventories of unsold homes rising, are more pessimistic than they have been since the few months immediately following 9/11.

The Fed is also aware that the boil is coming off house prices, which will force consumers to stop treating the value of their homes as ATM machines. Dan Hodin, a leading property lawyer in the fast-growing area (government is a growth industry) around the nation’s capital, says that the “refi market”, used

by consumers to extract equity from their homes to fuel their consumption, has “slowed to a trickle.”

Most important, the Fed now feels that its successive raises of short-term rates are finally being reflected in long-term interest rates. So it might soon indulge itself in what the CocaCola ads once described as “the pause that refreshes”, and allow the rise in long-term rates to cool the economy.

If the Fed indeed calls halt to the ratcheting up of interest rates, it might be missing an opportunity to keep inflation under control. Commodity prices are soaring, profits and share prices are providing upside surprises, the US economy is moving smartly ahead, consumers continue to troop into retail stores in search of their hearts’ desires, congressional spending shows no sign of tapering off, the labor market continues to tighten, and the economy’s excess capacity is rapidly being sopped up by rising demand.

Equally important, when the Fed signals its intention to stand pat at 5%, or 5¼, the dollar will be less attractive to investors, just when an increase in interest rates in recovering Japan will be diverting some cash flows from US to Japanese assets. Other downward pressure on the dollar will come from overseas investors’ fears that the Dubai World Ports fiasco, and the legislation that congress is now considering to tighten the review process for foreign acquisitions, is signaling a new wave of hostility to foreign investment. These investors are looking for alternatives to US assets – not easy to find, I might add.

This weaker dollar will make foreign goods more expensive in the US, and relieve some of the pressure that has forced domestic producers to

refrain from raising prices. Which is one reason why core inflation (excluding food and energy) in March increased at the most rapid rate since 2001, according to a report by Goldman Sachs, as rents, apparel and hotel prices rose. Throw in petrol, which is headed past the \$3 per gallon mark, a 25% jump since last year, and you have the inflation hawks gnashing their teeth at hints that the Fed will say enough is enough after its May meeting.

In addition to an effective end to efforts to forge a meaningful free trade agreement, a likely halt in the Fed's rate-raising programmed, and a softer dollar, we can reasonably guess that the era of high-priced oil and petrol will not end any time soon. OPEC is just about at the limit of its near-term ability to pump more oil, and is unwilling to grant access to the Western investment and technology it needs to increase output in the longer term. Iran has every incentive to continue roiling markets by rattling its nuclear saber. Threats to continuity of supply that push prices up by, say, \$5 per barrel, increase the Mullah's income by over \$100 million per week. Not a bad fee for a threatening speech or two.

Of course, all bets are off if we decide to take out Iran's nuclear facilities, or ... add your own nightmare. Even then, the US economy will snap back, as it did so quickly after the disastrous attack on the nation's financial center on September 11. So if you investors can keep your heads when disaster strikes, you can be rich men, my sons.



THE SUNDAY TIMES

A version of this Update appeared in
The Sunday Times (London)